

School for Traders & Investors

Twenty-Fourth Lesson

Excessive Distribution of Risk or How a Good Rule May Be Overworked

THE principle of the distribution of the risk in speculation or investment is fundamentally sound, but like all good things it may be carried to extremes. Few investors or traders concentrate their operations on a single security, or, in other words, place all their eggs in one basket. To do so with any assurance of success would require such a high degree of safety that the investment yield would be low, and the probability of speculative profit would be small, if it existed at all. Therefore, most investors distribute their available funds over several issues, so as to gain the advantage of the speculative possibilities of different industries, and at the same time limit the risk of loss in one or two of the commitments that might go wrong.

Many traders limit their activities to five or ten carefully chosen stocks, on the theory that it is difficult to watch too many issues at the same time, and keep properly in touch with all of their ever-changing fundamental and technical market characteristics. On the other hand, there is the speculator who buys a few shares of every stock whose market action suggests that it may be about to move, on the theory that a large percentage of his available capital will be in active issues, with a probable large number of aggregate points profit, and at the same time that he will secure an advantageous distribution of risk.

There are two possible dangers in the latter method that must be guarded against. First, the available capital is spread out in a thin layer over a wide list of miscellaneous stocks, whose individual gyrations may be difficult to watch in an active market, especially during a sudden general reaction, when on the spur of the moment a decision must be made as to which issues should be dumped overboard in order to protect the trader's equity. Second, such a practice is likely to lead to the abuse of over-trading, with the result that when the crisis suddenly

arrives, as it is almost certain to do eventually, the trader's judgment is impaired by anxiety over the realization that he has overplayed his hand.

In either case, it is probable that many of the commitments made during the latter part of his buying campaign were not chosen with the same care as those near the beginning, and that there was a certain degree of increasing over-confidence displayed in their selection as the market advance gained headway—as it approached its temporary climax, in the form of a weakened technical position requiring correction, or a reaction, or a shake-out, or a bear drive, or whatever

erly watched, with a view to both technical and fundamental considerations. From a list of, say, twenty different stocks, all of which are in favorable technical position for purchase, it is reasonable to suppose that ten of these issues are in far better fundamental condition than the other ten, and offer a better foundation for the expectation of rising prices. Then it is logical for the trader to concentrate on these favored issues, for their better intrinsic qualities are likely to be reflected in their market behavior in due time, other considerations being equal. By other considerations we refer to such special influences as average activity, market sponsorship, and speculative popularity or leadership. It is to be observed that the frequently-present element of manipulation is usually reflected in the technical action of the issue.

By limiting operations to those issues than can be kept under careful observation, the trader becomes well acquainted with his stocks and knows when he can depend on them in emergencies; in fact, he may often select them with this idea in view, just as an officer in charge of a hazardous military maneuver is more likely to succeed with a troop of picked men, regarding whose personal characteristics and staying qualities he is confident.

As the campaign develops, certain stocks will give a much better account of themselves than others. This will not only confirm the original judgment in their selection, but also indicate on which issues additional buying power may be concentrated to advantage. If technical considerations indicate a substantial advance, the most attractive units may be used to advantage for conservative pyramiding operations, provided ample equity is maintained to take care of any probable emergency. From time to time during a definite market swing, additional attractive issues may be added to the trader's (Please turn to page 715)

The principle of distribution of funds in securities is valid only as long as it is not applied to excess. This article shows the danger of improper diversification. The points raised should be carefully considered by every investor and trader, as failure to follow the principle herein enunciated must inevitably lead to loss.

you care to call the phenomenon which is often so disagreeable, or disconcerting, or shocking to an overloaded bull. During such market squalls, thin margins may fade away like air castles, and anticipated clean-ups may assume the chief characteristics of mirages in the desert.

The lesson we wish to inculcate is that the virtue of consistent distribution of risk may sometimes degenerate into the vice of over-expansion of credit, especially if the trader is short of market experience, and long of zeal. For the novice in this respect it is only a step from assiduity to asininity.

Experience indicates that it is unwise to trade in more stocks than can be prop-

➡ Moral: Don't Try to Spread All Over the Board ⬅

SCHOOL FOR TRADERS AND INVESTORS

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line, but all supplementary trades require study and attention, and on final analysis the largest profits are to be found in the veterans of the campaign, and not in the raw recruits.

Actual experiences of an active trader during recent market swings serve to confirm the truth of the above observations. For example, 13 original commitments showed an aggregate profit of 160 points, and a loss of 2 points; whereas 5 additional commitments made after the campaign was well under way showed an additional profit of 7 points, and a loss of 5 points. Another successful campaign began with 18 commitments which eventually showed a profit of 103 points, and a loss of 2 points; and 9 commitments made later resulted in 52 points additional profit, and 17 points additional loss. Again, a losing campaign began with 17 commitments which returned 16 points profit and 24 points loss; and 7 supplementary commitments showed 2 points additional profit and 10 points additional loss.

GRADUAL UPWARD DRIFT IN BUSINESS

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been no relief from the high raw material costs which have so seriously interfered with the normal course of trade, on the contrary, raw wool is in a strong position and seems likely to go higher, while cotton is still comparatively high although it has receded considerably from peak levels.

Primarily, the difficulties of cotton and woolen goods manufacturers seem to have started with their over-enthusiasm of last Spring when production was increased beyond limits which later demand justified. Retailers and distributors have been buying on a hand-to-mouth basis for many months with the result that producers have been compelled to carry top-heavy inventories, a large percentage of which would ordinarily be in the hands of distributors.

Weather conditions have further aggravated the problems of the manufacturer who has been operating on a sharply restricted basis for months. At present there is little to suggest any material turn for the better in the near future so far as cotton and wools are concerned. The silk industry is in a better position and is enjoying fairly stable conditions in the raw material market for the first time in years.

CORRECTION

In our January 19 issue we published an inquiry on Hecla Mining Company which, owing to a printer's error, contained information relating to another company. In view of this error and the misunderstanding that might arise out of it, we published a more complete analysis of the company in our February 2 issue.

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